Mr Borden

Borden Exhibit M-17-1

A submission by
Glenn E. Nielson, President
Canadian Husky Oil Ltd.
to
The Royal Commission on Energy
Montreal, Quebec, July, 1958

BEFORE

THE ROYAL COMMISSION ON ENERGY

A SUBMISSION BY

GLENN E. NIELSON, PRESIDENT
CANADIAN HUSKY OIL LTD.

AT

MONTREAL, QUEBEC

July, 1958

Mr. Chairman, members of the Commission, I appreciate this privilege of appearing before you today to discuss some of the rather acute problems that are facing the young Canadian oil industry. I appear as President of Canadian Husky Oil Ltd. and also as President of Husky Oil Company of the United States. Naturally, my interest lies with the smaller independent companies and their problems.

Many of the problems confronting the smaller companies in Canada and the United States are quite comparable. In both countries we are suffering from a lack of adequate markets. In both countries the shortage of markets is due to imports of crudes and refined products. In both countries the shortage could be corrected by effectively limiting imports.

This similarity does not apply in the problems facing the producers of natural gas. Here Canada has a tremendous surplus of shut-in reserves which are being withheld from ready and willing markets in the United States through lack of government action. In

the United States, gas producers are the healthiest part of the industry. In Canada they have a definite problem in financing the drilling of the wells necessary to validate their leases.

Before proceeding further, it is perhaps appropriate that I give you some of the background of the two Husky companies which I represent.

In 1938, I was instrumental in organizing Husky Oil Company in the United States. Our entry into the oil industry was on a very modest basis. We managed to assemble sufficient capital to make a down payment on a 1,000-barrel-per-day skimming plant in Cody, Wyoming, and four small wells which were producing low gravity asphalt type crude oil. At that time there was no market for this oil in Wyoming.

Working almost exclusively with heavy crudes, we built a business that by 1946 was in a position to carry on its own limited activities and at the same time make a modest entry into the young Canadian industry. Our entry was prior to the discovery of Leduc.

At the time of its organization in 1947, Canadian Husky Oil Ltd. was a wholly owned subsidiary of Husky Oil Company. As soon as the Canadian company had sufficient operational assets to assure its continuation, shares were sold to Canadian investors. In 1953, Canadian Husky was spun off; and since that time it has been completely separate from the American company. The only ties between the two companies are certain common shareholders, myself as President,

the United States, gas producers are the hardest part of the industry. In Canada they have a definite problem in financing the drilling of the wells necessary to validate their leases.

Before proceeding further, it perhaps appropriate that I give you some of the background of the two Husky companies which I represent.

In 1938, I was instrumental in organizing Husky Oil Company in the United States. Our entry into (the oil industry) was on a very modest basis. We managed to assemble sufficient capital to make a down payment on a 1,500-barrel-per-day skimming plant in Cody, Wyoming, and four small wells which were producing the gravity asphalt type crude oil. At that time there was no market for that oil in Wyoming.

Working almost exclusively with heavy crudes, we built a business that by 1946 was in a position to diversify its own limited activities and at the same time make a modest entry into the young Canadian industry. Our entry was prior to the discovery of Leduc.

At the time of its organization in 1946, Canadian Husky Oil Ltd. was a wholly owned subsidiary of Husky Oil Company. As soon as the Canadian company had sufficient operational assets to assure its continuation, shares were sold to Canadian investors. In 1953, Canadian Husky was spun off, and since that time it has been completely separate from the American company. The only ties between the two companies are certain common shareholders, myself as President.

and two other directors who serve on the boards of both companies. Eight of Canadian Husky's eleven directors reside in Canada.

I think it is worthy of mention that at the present time both companies are fully integrated, having activities in exploration, production, refining and marketing. The Canadian company has shown more rapid growth and now has approximately 50 percent more oil and gas reserves and is refining about twice as much crude. However, the American company is larger in marketing of refined products.

You may also be interested to know that I was born in southern Alberta and raised on a ranch in the Cardston district. My wife and three of our five children were also born in southern Alberta. I graduated from the University of Alberta with a degree in agriculture and economics and was engaged in sheep ranching through the difficult years of 1928 to 1934. A combination of discouraging circumstances finally resulted in my seeking employment as a salesman with a small oil company in Montana. This experience later led to the organization of Husky Oil Company.

This information on my personal background is given only to show you that I have an interest in Canada beyond ordinary business interests. My most satisfying experience since entering the oil business was to return to Canada and in a modest way commence what is now Canadian Husky Oil Ltd.

THE NATURE AND IMPORTANCE OF INDEPENDENTS

First, I would like to discuss the nature and importance of what are known as independent oil companies and independent oil operators. Through the years, the terms "majors" and "independents" have been used to designate two somewhat similar yet different components within the oil industry. Majors are large, well established, usually fully integrated companies, frequently having world-wide interests and well established and varied sources of income. Their common shares are widely distributed, and their activities are directed by what might be termed "professional management."

The term "independents" is used to designate both individual and company operations ranging in size from very small ventures which may comprise only exploration, production or refining to rather substantial enterprises which may be fully integrated. One of their main distinguishing features is that they are usually guided by an individual who is a substantial or even a majority shareholder in the company. In most cases their operations are confined to one nation, and often to one locality. Their limited activities make them particularly vulnerable to dislocations in the oil economy which persist for any extended period.

Their importance to the oil industry, both in the United States and Canada, can be shown by the number of exploratory wells they have drilled. In the United States, for many years the independents have drilled from 75 to 80 percent of all exploratory wells.[1] In Canada they

---

(1) Independent Petroleum Association of America.

THE NATURE AND IMPORTANCE OF INDEPENDENTS

First, I would like to discuss the nature and importance of what are known as independent oil companies and independent oil operators. Through the years, the terms "majors" and "independents" have been used to designate two somewhat similar yet different segments of the oil industry. Majors are large, well established, usually fully integrated companies, frequently having world-wide interests with well established and varied sources of income. Their common shares are widely distributed, and their activities are directed by what might be termed "professional management."

The term "independents" is used to designate both individual and company operations ranging in size from very small ventures, which may comprise only one person, predominantly engaged in exploration, to substantial enterprises which may be fully integrated. One of their most distinguishing features is that they are usually guided by an individual who is a substantial or even a majority shareholder in the company. In most cases their operations are confined to one nation, and often to one locality. Their limited activities make them particularly vulnerable to disturbances in the oil economy which persist for any sustained period.

Their importance to the oil industry, both in the United States and Canada, can be shown by the number of exploratory wells they have drilled. In the United States, for many years the independents have drilled from 75 to 80 percent of all exploratory wells.(1) In Canada they

(1) Independent Petroleum Association of America.

drilled 46.3 percent of the exploratory wells in the Prairie provinces from 1949 to 1957.(1) They also have drilled or participated in 52.3 percent of the discoveries leading to the 310 oil and gas fields discovered in Canada since 1904 that were in production or were capable of production in 1957.(2)

Few people realize what an important part independent oil companies and individual operators play in the industry. Because of the headline-grabbing of a few extroverts, the common conception of the independent oil operator is completely erroneous. In contrast to the overpublicized few, the average independent oil operator, of which there are some 30,000 in the United States, has no greater income than many other far less publicized businesses. These thousands of small businessmen are the very heart and soul of the oil industry. When the independent is sick, the industry is sick. Because the oil business supports an entire community of allied industries, it is impossible to affect its welfare without affecting the economy of the entire country. History has proved this many times in the United States.

If you will pardon my reference to our own company, I would like to discuss the history of Canadian Husky, first because I am familiar with it, and second because I think it portrays quite well how independents operate and something of their value to the oil industry and the general economy of the country.

---

(1) Yearbooks of The National Oil Scouts and Landman's Association.
(2) Compilation of oil and gas fields by <u>Oil In Canada</u>.

When we made our decision in 1946 to enter the Canadian oil industry, we began by constructing a small second-hand refinery at Lloydminster. The oil there is a low gravity crude yielding a large percentage of very high-quality asphalt and bunker fuel but a low percentage of high-profit gasoline and distillates. This is a side of the oil business not likely to stimulate the interest of a large company. Our initial investment at Lloydminster was about $150,000. Over the next ten years our own total capital and operating expenditures in the Lloydminster area alone amounted to more than 48 million dollars, and expenditures by other operators who joined with us in development programs in that area have totalled many millions more. We have no way of knowing how much has been spent by operators or producers in the area working independently from our operations, but we assume that it has been at least equal to or more than we have spent.

Any comparison of Lloydminster today with 1946 will show the contribution of independents to its development. From a small town dependent almost entirely upon agriculture for its economic livelihood, Lloydminster has become the tenth city in Alberta and Saskatchewan, with a high degree of industrialization. It is a clean, progressive city whose citizens enjoy a standard of living comparable to that of many larger cities.

I do not mean to imply that Canadian Husky has been entirely responsible for this growth. But we have been a major factor and we, along with many other small independent companies, are responsible for

the changed economy and growth of Lloydminster. I am sure than any impartial study of the activities of independents throughout Western Canada would give them credit for being a major factor in the improvement of not only Western Canada's but the entire nation's over-all economy.

CRUDE OIL MARKETS

I know the Commission realizes that the real problem facing the young, dynamic oil industry in Canada today is lack of markets for the crude oil it is presently able to produce. I have been surprised at the number of suggestions made to the Commission that export of crude to the United States is the answer to our shortage of markets. This to me represents wishful thinking.

Let us consider for a moment the oil situation on a world-wide basis. While I have been unable to obtain figures on world oil productive capacity, I doubt that any oil company official would question the statement that today we have a greater world surplus of oil than has ever been known in the history of the industry. What is more, the search for oil is proceeding at such a terrific pace that every indication points to still greater surpluses before production and consumption can be brought into balance. To illustrate the pace of foreign exploration by American companies, I would like to submit the report The Shift of World Petroleum Power Away From the United States, by Leonard M. Fanning, as Appendix A to this submission. Table seven in the report shows the scope of world exploration. How many years it will take to balance production and consumption, I certainly am not in a position to hazard a guess.

However, I do know that the increasing and excessive importation of foreign crude oil and products since the end of World War II has had a tremendous impact on the independent oil man in the United States. The following table shows the steady upward trend in imports of crude oil and and finished products:

IMPORTS OF CRUDE OIL

AND REFINED PRODUCTS INTO UNITED STATES

(Daily Average Barrels)

	Crude Oil	Refined Products	Total
1948	353,000	161,000	514,000
1949	421,000	224,000	645,000
1950	487,000	363,000	850,000
1951	491,000	354,000	844,000
1952	573,000	380,000	952,000
1953	648,000	386,000	1,034,000
1954	656,000	396,000	1,052,000
1955	782,000	466,000	1,248,000
1956	934,000	502,000	1,436,000
1957	997,000	548,000	1,544,000

Source: American Petroleum Institute, Statistical Bulletin,

Vol. XXXIX, No. 18, April 7, 1958, Form No. 7.

This means that over 563 million barrels were imported into the United States during 1957, notwithstanding the plight of the United States producer who had no foreign oil to bolster his income. These imports have resulted in a steady decline in the allowable production during the last six years in Texas, the largest producing state:

Year	Average allowable production in days per month
1952	21
1953	19
1954	16
1955	16
1956	15.8
1957	14
First six months 1958	8

If the present decreased allowables and increased imports of crude and finished products continues long, many independents will be in difficult circumstances. As one oil man so aptly put it, "There is no immediate danger of our country running out of oil. But there is a very real danger of running out of oil men."

Now let us see how reduced markets have affected the American independent since World War II. I know of no better example of their plight than the story of Glenn McCarthy. After the war, the McCarthy star rose fast as the spectacular oil man discovered one oil field after another. He had big plans. He wanted his money to work for him and for his community, to create jobs and wealth for himself and many other people.

To carry out his plans, he needed cash. So he borrowed huge sums, using his oil reserves as collateral and pledging his production to pay off the loans. He built a gasoline plant, a chemical plant, and the famous Shamrock hotel in Houston. He established 14 newspapers, a natural gas distributing company, and a motion picture production firm. He bought a radio station and a steel mill. He created dozens of payrolls and hundreds of jobs. He was a one-man boom.

Then the State of Texas found it necessary to drastically curtail oil production as imports cut into markets. That pulled the rug out from under McCarthy. There were other considerations, of course, but the cut in Glenn's oil income made it impossible for him to pay off his creditors as scheduled. The crash was heard round the world.

I might add that properties which were taken over by the receivers have not only paid off the obligations in full but still have a residual value of many millions of dollars. McCarthy's problem was basically that which faces many independents in the United States where they are forced to operate on borrowed capital. I am afraid it is comparable to what many are facing today, both in Canada and the United States.

Now, let us turn to our own situation here in Canada. Less than half of Canada's petroleum needs are supplied from her own production. In 1957, 53.5 per cent of Canada's consumption consisted of imported crude and refined products. (1) During the same period, her own wells were producing at the rate of only 57 per cent of their potential, and a portion

---

(1) Compiled from Dominion Bureau of Statistics <u>Refined Petroleum Products--1957.</u>

of this production was being exported to the United States.[1]

I do not pretend to be an economist who can evaluate the policy of continuing to purchase foreign crude and refined products while our own natural resources are shut in. But it does not take an economist to forecast rather accurately what the effect will be upon the economy of the independent oil operators of Canada if this condition continues. Nor will I hesitate to state that if this condition continues, the oil industry, particularly the smaller operators, will not be in the healthy position that has enabled them to develop this wonderful natural resource for Canada. It is my firm belief that anything that affects the economy of the oil industry affects the economy of Canada.

If I may, I would like to refer again to Canadian Husky to illustrate the seriousness of present conditions. In 1957, our cash flow from oil and gas production amounted to $1,107,356. Had we been able to produce and sell crude oil at our maximum permissible rate, our cash flow from oil production alone would have been in excess of $4 million. If we had been able to market even the minimum amount of natural gas under two contracts which we have signed, this would have added another $2 million to our cash flow.

In developing these resources we have incurred annual financial obligations such as sinking fund payments, interest, rentals on leaseback properties and preferred stock dividends which in 1958 will amount to $1,924,000. This means that in 1958 eighty-four per cent of our total

---

(1) Canadian Petroleum Association.

cash flow will be required to meet fixed obligations. This leaves only 16 per cent, or $360,000 for depreciation, depletion and exploratory write-offs which last year totaled $2,904,610.

This may appear on the surface to be very poor management. But when you stop to consider that if we could produce our oil and gas at potential, our estimated cash flow for over all operations in 1958 would be in excess of eight and one-third million dollars, well over four times our fixed obligations, it puts management in a better light.

I would like to add that thanks to the wise and helpful assistance of our Canadian investment bankers, Canadian Husky today has over $12 million in cash and available loan commitments. But even with this strong position, we may be hard pressed to meet our obligations if the current lack of markets is unreasonably prolonged. Part of this $12 million is allocated for the drilling of development wells which may or may not be drilled. With today's oversupply of crude oil, I doubt the wisdom of further development drilling beyond that required to retain known productive acreage. As recently as two weeks ago, our Executive Committee met and decided that further cuts in our drilling program were necessary because of our greatly reduced level of income. I am sure many other small independent operators are faced with similar problems.

To me it is regrettable that independents should be so adversely effected now, with our present world and national surplus of oil, when in the years ahead all the oil that has been discovered will doubtless

be required to meet the growing economic conditions of the world. But this is small consolation to the independent operators who, in the interim, may be forced out of business. Additional market outlets must be found now for Canadian crude if our industry is to maintain a healthy growth.

Referring again to the representations made to this Commission that the natural and logical markets for our crude oil are in the United States, I would like to point out two basic fallacies to this contention. First, as we have already seen, United States producers are facing markets nearly as curtailed as our own. Second, even if the United States were to import all of its petroleum requirements, Canadian crude oil could not compete economically with other foreign crudes except in a few of the border areas.

Some Canadian operators may feel that the movement of their oil into the United States has already been restricted by the United States Government. This assumption is not correct. The restriction has been a competitive one brought about by the purchasers of oil in the United States and not by the voluntary quota system presently being tried.

For the period from July, 1957 to April, 1958, actual imports of Canadian crude into the West Coast were about 25 per cent less than the amount authorized under the voluntary import quotas. Imports by purchasers into Districts I to IV of the United States, the area east of the Rocky Mountains, were nearly nine per cent less than the amount allocated.

Even if greater imports were allowed in the United States the

far Eastern, Middle Eastern and Venezuelan producers would take more vigorous steps to secure still larger portions of the market.

The costs of finding and developing a barrel of crude in the various oil producing countries shows how impossible it is for Canadian or United States producers to be competitive. For the years 1951 to 1955 these costs were: (1)

United States	$1.12
Canada	.95
Venezuela	.21
Far East	.15
Middle East	.005

The principal reasons for this wide difference in costs are the reserves per well and production per well. For the year 1956 these were: (2)

	Total wells	Reserves per well (barrels)	1956 Production per day per well (bbls.)
United States	554,774	55,000	12.9
Canada	10,946	260,000	42.4
Venezuela	13,965	1,005,000	175.9
Far East (Indonesia)	1,972	3,040,000	130.0
Middle East			
Kuwait	211	237,000,000	5,179.0
Iran	65	492,000,000	8,335.0
Saudi Arabia	114	369,000,000	8,650.3
Iraq	48	460,000,000	13,286.7

In the Chicago-Detroit-Toledo area, which has been suggested as a potential market for Canadian crude, refineries are already served by a network of pipelines from the producing areas of the Southwest and Mountain states. Any gains by Canadian producers would be at the expense of United States producers who are fully capable of supplying this market. As long as low-priced foreign crude is imported into areas where the United States producers are at a price disadvantage, I see little possibility

---

(1) Petroleum Outlook - March, 1958 published by John S. Herold, Inc., geologists and engineers.

(2) Petroleum Outlook - November, 1957.

of their relinquishing even a portion of the Chicago market to Canadian crude.

The handling of the import problem in the United States and Canada reminds me of a story told recently by an independent oil operator. He stated that this import problem reminded him of a recent visit to a mental hospital. One of the tests they used for determing whether the mental capacity of a patient was sufficient to justify his release was to put the patient in a room with a mop and a water faucet running. The task assigned was to mop up the water. If the patient did not turn off the faucet but merely kept on mopping, he was kept at the hospital for further treatment.

I think this analogy illustrates the way we are handling the import problem on both sides of the border. In fact, the patient is gradually opening the tap a little more each year.

The only area where we can exercise control of markets for our oil is Eastern Canada. I see no hope except to construct a crude oil pipeline to the Montreal area. Only through the building of this line and direct government action to restrict imports can we assure additional markets for Western Canadian crude production.

I will refrain from making any reference to the economics of building an oil pipeline to supply the Eastern Canadian markets because I know that other operators have presented rather complete briefs on this topic. However, I would like to make this observation: The Trans-Canada gas pipeline was originally regarded as uneconomical. For security reasons, the Government saw fit to assist in its construction. Today it appears to be completely able to stand on its own feet and liquidate the cost of building it in a reasonable period of time.

A crude oil line to Montreal should also be considered in the light of our national defense. From this standpoint alone, such a pipeline might be justified. I need not remind the Commission that our domestic and industrial energy requirements are many times more dependent on petroleum now than in 1939. Should war cut off foreign crude supplies, our eastern industry would be very seriously crippled.

Historically, our Canadian industry has been developed on the basis of imports and exports, primarily because in our early days we did not have enough production to supply all of our own markets. But we have completely changed our position since then. Our productive capacity now exceeds even our total Canadian markets, and all authorities agree that we will find more oil in the future than we have found to date. It is high time we look to our own markets to sustain our growth and the economy of Canada.

The problem now and for the foreseeable future is to maintain markets which will encourage maximum development of the Canadian oil industry and make it possible for independent oil companies to stay in business. In Canada, this can only be done by reserving our domestic markets for Canadian crude production. It seems wrong to me that Canada, the world's third largest consumer of petroleum products, should look beyond its own borders for a market for its crude oil production, while at the same time allowing more than half of its own market to be supplied from foreign sources.

NATURAL GAS MARKETS

Another serious problem is the lack of a clear-cut government policy for the export of natural gas. This presents a paradox that I have been unable to understand. With respect to oil, we are not only seeking markets in the United States, but we are critical of the United States for not playing the big brother in purchasing our oil. At the same time, we are sitting here with tremendous reserves of natural gas, unable or unwilling to reach a decision on an export policy.

There are American markets available and purchasers now ready to buy hundreds of millions of cubic feet per day, and one purchaser anticipates their requirements to exceed one billion cubic feet per day in a comparatively short period of years. I am quite familiar with the legal battles presently before the Federal Power Commission, and I attribute some of the delays to this condition. But Canada is primarily responsible for withholding this great potential source of revenue from market by making a political football out of the gas export question.

Of course, I can understand why governments should be concerned about first supplying the requirements of their own people. But when conservative engineers estimate Canada's present supply of gas at 24 trillion cubic feet, and all agree that this is only a minor part of what exists and will be discovered if gas is allowed to serve markets, I cannot understand why there should be any further hesitation to export the surplus of this vast natural resource.

It staggers my imagination to contemplate what the development of this one natural resource alone can do for the economy of Canada. However, markets that have been available in the much coveted Chicago-Milwaukee-Minneapolis area, the Pacific Northwest and California are gradually being supplied from other areas while Canada is trying to decide what action should be taken.

For three years I sat on the board of directors of Northern Natural Gas Company. During that time I observed the battles of Northern and other companies to purchase Canadian gas. I also observed the extension and expansion of the capacity of the lines of various companies to the south when they would have preferred to build new lines to use the closer Canadian reserves that even then were available. The same thing happened on the Pacific Coast. The Commission is familiar with the line that has been built from the southern part of the United States all the way to the Pacific Northwest to serve a market that was potentially one of Canada's best natural markets.

I hope you will pardon my being so disturbed over the delay in the export of natural gas, but my interest in Canada makes me feel that governmental bodies should have encouraged the export of gas in every possible way instead of continually delaying it.

CONCLUSIONS

In conclusion, may I refer to eight questions that the Commission specifically asked me to answer. I believe these questions have all been answered partially in my submission, but to insure direct answers, I will refer briefly to each question.

1. What is the effect of reduced crude oil markets on independents?

Normally, the independent relies largely on the sale of production to finance its increasing or expanding operations. It must have a continuing or expanding market rather than a reduced market if it is to stay in business and operate effectively.

2. Would independents be endangered each time crude markets were reduced?

The management of an independent anticipates fluctuating markets and is usually able to cope with the normal cycles of supply and demand without being seriously affected. However, extended periods of market curtailment caused by external factors, such as imports over which they have no control, can be very serious threats to their existence.

3. Can danger to independents caused by reduced markets be avoided?

To my knowledge, there is no way to prevent hardship to some independents each time a period of reduced crude oil markets occurs, and I do not believe preventive measures designed to eliminate all risks would be desirable even if they were possible.

However, the independent's vulnerability to adverse external factors, such as foreign crude oil markets, can be lessened by government-enforced import quotas.

4. Are independents more important in the United States than in Canada?

The figures previously given show that independents in the United States drill 75 to 80 percent of the total exploratory wells as compared to 46.3 percent in Canada. I have no other specific information upon which to base an answer to this question, but it is my opinion, based on observation of independents in both countries, that the reason they played a lesser role in Canada is due to the taxation laws presently in effect. I shall refer more to this problem under question seven.

5. Is the small independent in Canada more vulnerable than the large independent?

I do not believe that the size of an independent determines the degree of its vulnerability except to the extent that larger companies may find it easier to finance their operations and may have more varied sources of operating income. Independents large and small in both countries are very vulnerable to competition with foreign produced crude oil.

6. Would the Canadian economy be seriously affected by consolidation of independents?

I would say, as a general observation, that consolidation results in larger companies which require more restricted and conservative

operations with less flexibility. Therefore, consolidation does have an adverse effect on the economy.

If consolidations are made voluntarily by both parties, they are generally equitable to all concerned, including shareholders. On the other hand, in periods of extremely adverse conditions such as we have now, many consolidations become forced sales. Under these conditions, realization of a fair value of assets can be considerably less than their true worth. The exercise of prudent business judgment should be the motivation for the decision to amalgamate, not the necessity of liquidating to satisfy creditors.

7. How do methods of financing weaken independents?

The very nature of the oil business requires long-term money. The expensive drilling and development of oil and gas wells usually result in an asset which will produce revenue from 10 to 20 years and sometimes longer. Long-term money is just not available to the small independent on the same basis as to the larger companies.

As I have shown in the case of Canadian Husky, during periods of severely depressed markets, debt retirement and other fixed obligations which must be paid after taxes may leave little or no funds from operating income for use in the search for oil. If an independent continues to deplete its reserves without adding to them, it is soon out of business.

The answer to this question is not complete without reference to the Canadian tax laws governing the right of individuals not in the

oil business to expense intangible drilling costs. The failure to allow cost depletion also affects the small operator adversely. It is an odd situation, but United States citizens are able to operate in Canada at an advantage over Canadians in similar circumstances.

In November of 1955 I submitted a brief to the Royal Commission on Canada's Economic Prospects which deals more fully with these problems and how they affect financing of small companies. I would like the privilege of placing this brief on the record of this Commission as Appendix "B" as part of the answer to questions seven and four.

8. Is the present surplus of crude oil in the United States temporary?

If imports of crude oil were controlled in the United States, there would be no surplus today. But examination of the tables on imports from 1948 through 1957 presents a very discouraging picture for the small operator or company depending on the current sales of his production to pay for the development of his reserves and to finance further exploration. Unless there is an unexpected change of policy in the United States, I am afraid neither Canadian nor United States producers can expect much market there.

Surely there can be no question concerning the importance of independents to the economy of the oil industry or to the general economy of Canada itself. Nor should anyone question the seriousness to this

economy of the lack of markets caused by imported crudes.

Independent operators may differ in what they believe to be the best course of action in solving the market problems, but all agree that shortage of markets is by far the most important problem confronting them today. They will also agree that there is great urgency to establish policies on both the import and export of oil and natural gas. In the oil business the successful operator must make long-range plans. Without some assurance of favorable future governmental policies, long-range planning is impossible and the outlook for the small company is anything but promising. May I urge the Commission to give full and careful consideration to these problems and make its recommendations for prompt action to the government of Canada at the earliest possible date.

Appendix "B"

STATEMENT OF GLENN E. NIELSON
President of Husky Oil & Refining Ltd.

before the

ROYAL COMMISSION ON CANADA'S ECONOMIC PROSPECTS

Calgary, Alberta
November 25, 1955

To any person interested in Canada and its future welfare, the purposes and possibilities of the Royal Commission on Canada's Economic Prospects are most encouraging. I consider it a privilege to be invited to appear before this Commission. My comments will be limited to certain aspects of the petroleum industry, an industry which I am convinced is destined to play an important role in Canada's future economy.

My personal experiences in Canada began a little over fifty years ago. I was born, raised, educated, married and we had three of our five children before we left the province of Alberta. Between 1928 and 1934, I farmed from 500 to 1,000 acres each year and ran 2,000 sheep. To anyone who farmed or ranched during that period, I need say no more. To others I have often said "My education included agriculture and economics at the University of Alberta, but when the economics went out of agriculture I was forced into a different business." Thus it was more necessity than choice that caused me to leave Canada in 1934 to start over again in the United States. I have made these personal references only to explain my deep and sincere interest in Canada, its people and its prospects.

In 1938 I organized and started a small oil business which is now known as Husky Oil Company, and when we decided in 1946 to participate in Canada's oil development, I felt a great deal of satisfaction. Young companies such as ours are normally not equipped to make long range economic studies like

those made by the older and larger companies, so I know there are others who have appeared or can appear before this Commission who are much better qualified to report on the 5-10-20 year future of the oil industry. However, by reason of the problems and difficulties which accompanied the building of two small integrated oil companies, one in Canada and the other in the United States, I do feel qualified to comment on some Canadian laws and regulations that can and do seriously affect the economic prospects of the Canadian petroleum industry and consequently of Canada itself. I have no intention of posing as an expert with technical knowledge of these laws and regulations relating to income taxes and financing, but no management can be unaware of their practical application and make sound business decisions.

In my opinion, the economic prospects of Canada will depend in large measure upon how well its petroleum resources are developed, and in that regard I would like to read the following statement with which I am in full accord:

> "A country's oil resources are best developed when all who are engaged in petroleum operations -- its own nationals and those of foreign nations --compete on equal terms. Favored treatment of one group at the expense of another, state monopolies, or state competition in any phase of oil retard maximum development...Finding oil calls for the efforts of a great many people of different characteristics. Despite the development of scientific methods, a major factor in discovery is still a willingness of many individuals and competing industry units, exercising independent judgments, to take risks. The chances of finding oil are increased as more people are encouraged to accumulate and venture their capital on their own initiative.

the participation of many....provides those multiple sources of initiative, imagination and responsibility, out of which springs a great variety of discoveries and inventions, new ideas, and tremendous productivity."

In disregard of such a basic and sound approach for developing the Canadian petroleum industry, there have been many complaints that U. S. money has come to Canada and taken over the oil business. It is true that considerable U. S. money has contributed to the rapid growth and development of oil and gas in Canada. Frankly, much of the progress of our Canadian company can be traced directly to the availability of certain U. S. capital which we frequently refer to as "tax money". The Canadian laws and regulations which I wish to discuss do not discourage this kind of U. S. money but they effectively block comparable Canadian money. I do not agree with Premier E. C. Manning's suggestion before this Commission that it has been a lack of faith which accounts for their relatively small participation in their country's oil development; rather, it is the tax provisions which are in their law. Strangely enough, it is the Canadian company and Canadian individual who are denied the opportunity to compete on equal terms with their U. S. counterparts.

With this unequal competition, it was only natural that vast sums of U. S. money came to Canada. It was something easy for me to see seven or eight years ago, not because of any great insight or discerning ability, but because I understood the prohibitive effect of certain Canadian income tax regulations on Canadian risk capital. U. S. capital will continue to play a major role in Canadian oil developments so long as so many sources of Canadian capital are economically precluded from participating. When our

Company was first planning to enter the Canadian oil picture, I expressed my feeling of concern at every opportunity to persons prominent in Canadian financial circles. Among them were Dr. W. C. Clark while Deputy Minister of Finance, Graham F. Towers, Governor of the Bank of Canada, S. G. Dobson while president of the Royal Bank of Canada, and Donald Gordon who later became president of the C. N. R.

The first income tax provision I wish to discuss is the one which denies a Canadian individual the privilege of using his income before taxes to drill oil wells. A. U.S. taxpayer may deduct such costs from his income regardless of the source of that income, and the result is that the U.S. taxpayer is risking the equivalent of as little as 10¢ on a dollar while the Canadian taxpayer is risking a full 100 cents. A well that could produce oil might be very successful to the U.S. taxpayer because of his small real cost, but it would not necessarily be so to the Canadian taxpayer who has a cost up to ten times greater.

Not only that, but for a Canadian individual to have any right to deduct oil exploration and drilling expenses, he must belong to a syndicate or partnership. And if he should be a member of two oil syndicates, one with income and the other with excess deductions, he is not entitled to offset one against the other.

Another tax provision is the one which considers costs of acquiring acreage for oil and gas prospecting as capital expenditures. If, after considerable more money is spent in evaluating and testing, the acreage is worthless, the Canadian taxpayer must recoup his acquisition costs after he has paid his income taxes. On the other hand, his U.S. competitor can recoup those costs out of his income before he pays taxes. If the two taxpayers

are companies, the economic result is obvious. The real cost to the U. S. company would be just about one-half of the cost to the Canadian company -- or, the U. S. company could afford to pay twice as much to acquire the acreage as the Canadian. The effect of such tax discrimination is not only ridiculous, it can and does have a detrimental result for a Canadian company trying to grow.

Suppose in a given year, a Canadian company raises $200,000 for an oil venture and a U. S. company, having other income, decides to spend $200,000 in Canada in the same way. They might even join together and buy two blocks of acreage costing $200,000 each. To simplify the example, someone else drills exploratory wells on the two blocks of acreage and one is worthless while the other is successful. The successful acreage produces $50,000 of income for the two companies so that each is entitled to half. From the standpoint of hard economic fact, each Company has lost a net $75,000 for that year's effort; $100,000 was lost in the worthless acreage and $25,000 was gained from the other. Yet, the Canadain company must pay taxes on its $25,000 while the U. S. company, though paying Canadian taxes on its $25,000, is entitled to deduct from its other income the $100,000 loss and the Canadian income taxes from its U. S. taxes on other income. Another way of expressing the same situation is that the Canadian company must secure twice as much income as the U. S. company in order to recoup that $100,000 loss.

For a company to continue in the oil business, it must continuously acquire and evaluate new acreage. A young company must use a large amount of its income attempting to find additional production, if it doesn't, it eventually dies. Reasonably, it should be able to measure and plan its

activity by the amount of its taxable income, but a Canadian company cannot afford to--it must gauge its activity by its income remaining after taxes.

The next tax provision which is detrimental to the Canadian participant in oil development is the manner in which the depletion allowance is applied. In the United States, the allowance is applied separately to each producing property and the operator is consequently encouraged to use his income after the depletion allowance for further acquisitions, exploration and development. In fact, if he does not do so he is eventually out of business. However, in Canada, the depletion allowance is applied only after expenditures for further exploration and development so that there is actually little, if any, depletion allowance. This is a real deterrent to a small company looking for oil, and as a matter of pure economics, the Canadian company should quit once it has found some production. Perhaps that is why there are many small Canadian companies not as active as they once were in what must be a never-ending search for new oil.

Another aspect of the depletion allowance is that in Canada there is no choice of method. The theory of percentage depletion is sound because it is based on very practical problems. Yet there should be the opportunity to choose what is termed "cost depletion" which is a depletion allowance directly related to the taxpayer's actual cost in a property. The purpose of and the principle behind the allowance for depletion is similar to the allowance for depreciation. It is through the allowances for depletion and depreciation that a taxpayer is supposed to be able to recover the cost of his assets which are producing income. However, the unavailability of "cost depletion" to a Canadian oil company results in a severe handicap. An example of that might be as follows:

It is entirely possible for one manufacturing company to have $1,000,000 invested in depreciable assets and another only $200,000--yet each earns $100,000 per year before any allowance for depreciation. It would be most unreasonable and unfair to limit the depreciation allowance of each to some arbitrary percentage of its income. Yet that is how the depletion allowance is provided for Canadian oil companies. It is that situation which makes it difficult if not impossible for a small Canadian company to borrow funds to buy developed properties, and why it can't compete in offering the going prices for properties put up for public sale. Without cost depletion, it is almost impossible for a young company to earn enough money after taxes to pay its debts and still grow. Many times our company up here has found desirable blocks of acreage and if it were subject to U. S. tax laws it could afford some of them. But up here it can't.

With these income tax provisions handicapping any Canadian desiring to participate, it has been only natural for U. S. capital to play an important role in developing Canada's oil industry.

But other laws and regulations shut off certain sources of capital to Canadian and non-Canadians alike. Once oil is discovered and the reserves properly determined, the oil well and the production from it is better security for a long term loan than is a building of bricks and steel. But it is many years before the investment in an oil or gas well is returned and, as I have indicated, it takes even longer for the Canadian operator. Because of that delay, debt capital must be available which can be repaid over a period of time more related to the income producible from the well. In the United States, the life blood of the small oil producer is long-term mortgage loans, and it was that kind of capital that enabled our U. S. company

to grow. However, at one stage in its growth, I became so discouraged with short-term financing that I had made up my mind to sell out if we could not obtain at least a ten year loan. Over a year of uncertainty passed during which I was constatnly seeking a long-term loan. Finally, the Chase National Bank in conjunction with an insurance company made us our first ten year loan and I can honestly say that our U. S. company's real progress dated from that time.

Consequently, it was a matter of serious concern to me, when I learned that banks and insurance companies here in Canada were not only unfamiliar with 10 to 15 year loans secured by oil properties but that they were prohibited from making them.

It is true that capital from common stock financing is more available here in Canada than it is in the United States, but there are strict limitations on that. In the early period of a company, common stock money can be very expensive because it discounts value and potential more than any other kind of capital. We have also found that debenture financing is perhaps easier in Canada, but our experience has indicated that it is manufacturing properties not oil properties which adapt themselves to such financing.

I firmly believe that the economic prospects of Canada's petroleum industry are practically unlimited, but by reason of present tax and financing laws and regulations Canadian citizens and Canadian companies are both handicapped and limited. They should be able to take a bigger part in the development of their oil resources, but because of restrictions on their ability to use income, the unnatural treatment of costs of acquiring properties, the unrealistic and limited application of the depletion allowance, and the unjustified restrictions on certain sources of funds, they

are handicapped in having to compete with foreigners on unequal terms. Without the full participation of Canadians, the entire development of Canada's petroleum industry will suffer.

In 1949, Dr. Joseph E. Pogue, a Vice-President of the Chase National Bank, and one of the world's leading oil economists, made an address before the Investment Dealers' Association of Canada in Toronto in which he said:

> "Experience with oil developments throughout the world has demonstrated that four conditions are necessary to attain really important results. First, the source must be adequate. Second, conditions must be such as to attract a multiplicity of competing efforts, to stimulate the application of complicated and costly technologies, and to encourage the formation of the necessary capital. Third, markets must be available or subject to development. And finally, the setting must be such as to inspire confidence for maintaining a continuity of effort."

I am confident that the undiscovered oil and gas reserves in Canada are greater than will be estimated by even the most optimistic petroleum engineer or economist. I believe even the markets which are now lacking will be developed. The flow of capital into Canada shows clearly that an atmosphere of confidence exists which will maintain that necessary continuous effort.

In the main, politics has stayed out of the oil business in Canada which is absolutely necessary in order to preserve that atmosphere of confidence that is necessary for the free flow of capital. Fortunately, there have not been many instances where political considerations rather than economic ones have influenced the industry's natural development.

There is no question in my mind but that Canada has before it a great and important future. I also realize that the petroleum industry in Canada is relatively new and it is only natural that the income tax and financing regulations have not been tested to the same extent as in the United States. In calling to your attention these adverse tax factors and financing impediments in Canada, I do so with the hope that these obstacles to the most efficient development of this great petroleum industry can be removed. Otherwise, Canadians will not be allowed to compete on equal terms with others nor will they play their full part in the development of oil in Canada.